STATE OF VERMONT
PUBLIC SERVICE BOARD

Docket No. 7060

Investigation into Mountain Water Company's rates which took effect April 1, 2005	)))	Hearing at Montpelier, Vermont November 14, 2005

Order entered: 1/20/2006

PRESENT: Thomas S. Lyle, Hearing Officer

APPEARANCES: Geoffrey Commons, Esq.
for Vermont Department of Public Service

John R. Ponsetto, Esq.
Gravel and Shea
for Mountain Water Company

I. INTRODUCTION

On January 14, 2005, Mountain Water Company ("MWC" or "Company") filed a petition with the Public Service Board ("Board") requesting to increase rates by 99.71 percent, impose a quarterly capital addition surcharge of $14.56 and make other changes to its rate design (Tariff Filing # 7051). The Company's filing was amended on January 21, 2005, to reflect an effective date of April 1, 2005. The petition was supported by the prefiled testimony and exhibits of Mr. Thomas E. Yarger, Certified Public Account, on behalf of MWC. Notice of the proposed tariff filing was provided to each customer by the Company.

In a letter dated March 17, 2005, the Department of Public Service ("Department") recommended that the Board allow the proposed tariff changes to go into effect as of April 1, 2005, subject to further investigation and hearings. In the event the proposed changes were found to be excessive, the Department also recommended that the Board require the Company to refund customers the difference between the revenues collected under the proposed rates and the Board-approved tariff changes. The Board accepted the Department's recommendation and incorporated them into Order dated April 1, 2005.

On September 30, 2005, MWC and the Department (the "Parties") filed with the Board a Memorandum of Understanding ("MOU") resolving the issues in this proceeding.

As a part of the MOU, the Parties request Board approval of a 56.94% increase in revenues, effective April 1, 2005. The proposed increase provides the Company with an opportunity to generate annual revenues of $150,499. Joint Exhibit-1, Attachment 1. Additionally, the Parties request approval of a quarterly capital addition surcharge of $14.56, effective beginning April 1, 2005, and ending January 1, 2006, and other customer charges. The Company also agrees to refund customers the difference in the amounts collected from customers since April 1, 2005, and the stipulated rates.

In this Proposal for Decision, I recommend that the Board approve the MOU. For the reasons more fully explained below, I conclude that the MOU is in the public good.

II. BACKGROUND

This docket arises from an investigation into the rates, charges, billing practices and management of the Company. Order of 10/6/04; Docket 6845. In that investigation, the Board approved a separate Memorandum of Understanding ("6845 MOU") between the Department and MWC which required the Company to:

(1) Request formal approval of current rates, including disconnect and reconnect charges, fire hydrants, late payment fees and fees for changes to bills;
(2) File corrected annual financial reports and maintain accounting records in accordance with the Board's chart of accounts;
(3) Install water meters at the Warren Fire Department and charge for services;
(4) File a plan to address water leakage in the system;
(5) File service contracts between MWC and the parent company or other affiliates;
(6) Develop a rate design; and,
(7) Determine the feasibility of changing the billing increments from 1,000 gallons to 100 gallons.

With the filing of the current MOU, the Company complies with the terms in the 6845 MOU, except for developing a new rate design.[1]

Up until the proposed rates took effect on April 1, 2005, the Company had been charging customers $26.00 per quarter, plus $1.27 per 1,000 gallons for an unspecified period of time. The rates approved in the Company's last rate case in 1982 were $26.00 per quarter, plus a design flow charge of $3.225 per 100 gallons.[2] Although MWC could not recall how changes in customer charges were made or when, it is apparent that the approved charges were considerably more than what the Company has been actually charging customers over the last several years.

Under the proposed tariff changes, the customer charge is $23.00 per quarter, plus $4.43 per 1,000 gallons consumed. The Company also proposes, in addition to the temporary capital addition surcharge of $14.56, a fixed quarterly charge for the use of fire hydrants and other administrative fees to recover the cost of reconnecting and disconnecting customers, and for making changes in customer billing records.

Criteria for Decision

Vermont law requires the Board to set rates that are just and reasonable. 30 V.S.A § 218(a). This is accomplished by relying on cost-of-service ratemaking methodologies. To arrive at an appropriate cost of service for the prospective rate year, actual expenses incurred over a 12-month period are adjusted for known and measurable changes which are expected to be incurred during the period in which the proposed rates will be in effect. Before rendering its decision, the Board takes into consideration the predictive value of the proposed changes. Although the Board has traditionally relied upon a Company's cost of service adjusted for known and measurable changes, the relevant statutes neither expressly require nor prohibit any specific methodology.

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1. The Parties continue to work toward resolving outstanding rate design issues and expect to submit a proposal for the Board's consideration within the next three to four months.

2. *See* Docket No. 4555, Order of 9/13/82. Although the Order found a quarterly charge of $3.225 per 100 gallons of design flow to be appropriate, the Board based its conclusion on the Hearing Officer's proposed finding that a charge of $.129 per gallon was just and reasonable. However, the Order does not include details of any calculations which convert the Hearing Officer's per gallon recommendation into a $3.225 per 100 gallon actual approved tariff rate.

The MOU reflects a bottom-line settlement between the parties where each agrees that the proposed rates are just and reasonable, but do not necessarily agree on specific elements of the overall request.[3] Areas of dispute remain over rate design and non-tariff water sales (also referred to as off-system bulk water sales). I address these and several other topics below.

III. Findings of Fact

Based on the evidence of record, I hereby report the following findings to the Board in accordance with 30 V.S.A. § 8.

A. Cost of Service

1. The Board first approved customer charges for MWC in 1982. Docket No. 4555, Order of 9/13/82.

2. Since 1982, rates were "somehow" reduced by a previous owner of Mountain Water Company. Tr. 11/14/05 at 13 (Yarger).

3. Historic test year financial reports for the twelve-month period ending July 25, 2004, accurately reflect revenues and expenses incurred in the provision of service. Tr. 11/14/05 at 17-19 (Martin and Yarger).

4. Under the MOU, the Parties agree customer rates should increase to produce a revenue increase of 56.94% and that such an increase is just and reasonable. Exh. Joint–1.

5. For the rate year, the annual cost of service is $150,499 and has been adjusted for known and measurable changes. Exh. Joint–1; Yager pf. at 2.

6. Up until January, 2005, MWC provided unmetered service to the Warren Fire Department free of charge. Pursuant to the 6845 MOU, the Company installed a meter at the Warren Fire Department and the Fire Department is now paying for service. Tr. 11/14/05 at 22 (Richards); Docket No. 6845, Order of 10/6/04 at 2.

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3. Exh. Joint-1 at 1–2.

B. Rate Design

7. MWC serves 658 customers and 25 fire hydrants. Commercial and residential customers pay the same rates for service. Fire hydrant rates are based on size. Exh. Joint–1, attachment 4.

8. Under the 6845 MOU, the Company agreed to develop a rate design that includes all connections to the water system, including without limitations fire hydrants and commercial establishments. Docket No. 6845, Order of 10/6/04 at 2.

9. Under the current MOU, the Parties discussed but did not resolve the question of an appropriate rate design. The parties will continue to negotiate rate design issues and intend to submit an agreed-upon rate design for Board approval. Any proposed changes to the current rate design will be revenue neutral. Exh. Joint–1 at 2.

C. Off-System Bulk Water Sales

10. In conducting off-system bulk water sales, MWC pumped a large quantity of water into customer-provided water transport trucks for delivery to distant locations off the system. There were two commercial customers taking delivery of bulk water. Tr. 11/14/05 at 21 (Richards).

11. Off -system bulk water sales are not a Board-approved tariffed service. Exh. Joint-1 at 3.

12. The Company no longer provides off-system bulk water sales but is currently exploring additional rate design changes to provide such services under an approved tariff. Tr. 11/14/05 at 26 (Jones).

D. Billing Increments

13. Pursuant to the 6845 MOU, the Company agreed to make a determination regarding the feasibility of changing its billing increments from 1,000 gallons to 100 gallons. Docket No. 6845, Order of 10/6/04 at 2.

14. On October 28, 2004, MWC filed a letter with the Board stating that a change in the billing increments to 100 gallons would cost approximately $38,000. Exh. Joint–2.

15. Given the other demands on the Company's limited financial resources, the cost of installing the necessary meters and billing software to change the billing increments from 1,000 gallons to 100 gallons is uneconomic at this point in time. Tr. 11/14/05 at 16 (Jones).

E. Financial Records

16. Prior to fiscal year end 2004, MWC's annual financial reports did not comply with the Board's chart of accounts. Tr. 11/14/05 at 18 (Yarger).

17. Pursuant to the 6845 MOU, MWC agreed to file with the Board a revised and accurate 2003 annual financial report. Additionally, the 6845 MOU requires MWC to maintain accounting records in a manner that facilitates ratemaking and regulatory review. Docket 6845, Order of 11/6/04 at 2.

18. With the Department's consent, MWC filed on October 1, 2004, its annual report for the fiscal year ending July 25, 2004 (rather than filing a revised 2003 annual report). This report complies with the Board's chart of accounts and accurately reflects the operations of the Company. Tr. 11/14/05 at 17 (Martin) and 18–19 (Yarger).

19. For the fiscal year 2004, MWC's external auditors issued an unqualified opinion of the Company's annual report and stated that the report was in accordance with generally accepted accounting principles. Tr. 11/14/05 at 20 (Yarger).

F. Water Variances

20. Each year MWC experiences differences in the amount of water pumped and the amount of water billed to customers. This variance is assumed to equal leakage in the Company's water system. Tr. 11/14/05 at 30 (Jones).

21. Water leakage grew from 6,223,700 gallons in fiscal year 2000 to 14,149,100 gallons in fiscal year 2004. In fiscal year 2005, leakage equaled approximately 12,589,500 gallons. Exh. Joint–5.

22. Pursuant to the 6845 MOU, MWC agreed to file a plan with the Board and the Department to address water leakage in the system. Docket 6845, Order of 10/6/04 at 2.

23. On August 27, 2004, MWC's parent corporation, Summit Ventures NE, LLC ("Summit"), issued a request for Proposals for assistance in developing a plan to detect and reduce water leakage in the system. MWC selected the engineering firm of DuBois and King, Inc., which is still in the process of developing a plan for MWC. Exh. Joint–2.

G. Management Service Contracts

24. Pursuant to the 6845 MOU, MWC agreed to enter into formal management service agreements with its parent company, Summit, and other affiliates with which MWC conducts business or shares costs. Docket 6845, Order of 10/6/04 at 2.

25. On May 26, 2005, MWC filed with the Board and the Department a contract with Summit. The contract provides that MWC will pay Summit for general administrative and management services. Although MWC did not enter into this agreement before filing its petition to increase rates and, therefore failed to comply with the Board's Order in Docket 6845, the Department does not recommend that the Board impose a penalty for non-compliance. Exh. Joint–1 at 2-3.

26. Based on the Department's review of MWC's financial records and information responses, MWC is not subsidizing Summit or any other affiliate. Tr. 11/14/05 at 72 (Commons).

H. Rate Comparability

27. MWC's proposed rates are fairly comparable to the rates of other small water systems in the State of Vermont. Exh. Joint–6.

I. Quarterly Capital Addition surcharge

28. MWC is required to comply with the State of Vermont Water Supply Division's rules and regulations in order to be permitted to provide services to customers. Currently, the Company has deficiencies in the system that must be addressed in the short term. Tr. 11/14/05 at 56 (Jones).

29. The $39,500 in capital additions identified by the Company are the minimum set of projects that the Company must complete in order to comply with the immediate requirements of the Water Supply Division. Exh. Joint–3; tr. 11/14/05 at 54 (Yarger).

30. A quarterly surcharge of $14.56, effective April 1, 2005, to March 31, 2006, to pay for these necessary capital additions is just and reasonable. Exh. Joint–1 at 2.

31. The amount collected under the surcharge is not to exceed $39,500. A special bank account has been set up to collect and disburse funds as capital improvements are made. Yarger pf. at 5; exh. Joint–3.

32. For future ratemaking purposes, customer surcharges will be treated as Contributions in Aid of Construction and will reduce the Company's rate base. Tr. 11/14/05 at 55 (Yarger).

33. As of July 25, 2004, MWC capital structure included a $26,630 deficit in equity. Exh. Joint–1, attachment 7.

34. In recent years, Summit has subsidized the Company's operating losses and paid for new capital additions. Tr. 11/14/05 at 79-80 (Richards).

IV. Discussion

Unlike most utility companies that seek rate relief from the Board on a regular basis, MWC last sought approval to set rates back in 1982. Since the last rate case, the Company has had to invest in new plant additions to serve customers and comply with increasingly stringent safe drinking water rules. These events have increased the Company's costs. In the MOU, the parties propose rates that reflect these higher costs.

Approval of this MOU would mark the conclusion of a multi-year effort on the part of the Department and MWC's management to improve the economic viability of the Company, because MWC's parent company, Summit, has been subsidizing the Company's operating losses over the past few years and paying for the capital additions. Such support can not be assured in the future as Summit has also sustained recent operating losses. With approval of this MOU, MWC would be placed in a better position to operate independently from its parent company.

Moreover, the circumstances which led to the opening of the investigation into the Company's rates, charges, billing practices and management in Docket 6845 have largely been addressed in this proceeding. During the 6845 proceeding and in the instant investigation, the Company undertook a series of actions to address concerns raised by customers and the Department. Therefore, I conclude that approval of the MOU is in the public good and results in rates that are just and reasonable.

As agreed to in Docket 6854, the Company has requested formal approval of its rates and charges. The request was based upon a revised annual report that complies with generally accepted accounting principles and the Board's chart of accounts. The Company has installed water meters at the Warren Fire Department and the Fire Department has begun to pay for services.[4] These revenues, which are relatively insignificant in relation to other customers, do not have a material impact – in either direction – on the revenue requirements of the Company.[5] The Company has engaged an engineering firm to develop a plan to detect and reduce leakage in the system. Some improvements in reducing leakage have already been made. MWC has entered into, and filed with the Board, a management service contract with its parent company. With the service contract on file, the transparency of the interactions between Summit and MWC will increase. Such transparency will deter cross-subsidies as the contract limits the amount of payments (for revenue setting purposes) to no more than $22,000 annually. Any amounts exceeding $22,000 or payments for services other than those specifically identified in the contract may not be recoverable in the next revenue proceeding, unless the Company justifies the increased expenditures. Pursuant to the 6845 MOU, MWC also filed a letter on August 28, 2004, outlining its efforts to determine the feasibility of changing the billing increments from 1,000 gallons to 100 gallons. According to the Company, the estimated $38,000 cost would be imprudent. Given the other demands on the Company's financial and personnel resources, it would not be feasible to make a change to the billing increments at this time. Fulfilling the above commitments legitimizes the Company's rates and charges, increases the transparency of the Company's operations and makes easier the task of reviewing records for future regulatory purposes.

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4. Tr. 11/14/05 at 22-23 (Jones and Richards).

5. Tr. 11/14/05 at 24 (Richards).

Although MWC previously committed to filing a rate design, the 6845 MOU did not specify a filing date. As a part of the current MOU, the parties have agreed to continue negotiating an appropriate rate design, including the sale of bulk water to customers located off the system. Any changes to the present rate design will be revenue-neutral. The intention of the new rate design will be to insure classes of customers pay their proportional share of the costs to provide water service. Just as importantly, the parties also intend to develop a rate design that establishes appropriate price signals for the use of water resources. This may result in the lowering of the customer charge and increasing the consumption charges to reflect the value of limited clean water resources in the service area. The parties have also recommended that a separate proceeding should be opened to consider rate design issues and that this proceeding should not be delayed any longer. I concur with the parties' recommendation, and recommend that the Board order the Company to file a rate design with the Board no later than March 31, 2006.

Capital Surcharge

The State of Vermont's Water Quality Division has recently reviewed MWC's system and found deficiencies regarding corrosion control and water sanitation.[6] Failure to remedy the deficiencies may result in enforcement action, including the possibility of penalties.[7] As a result, the Company needs to quickly make $39,500 in additional investments over the next 12–13 months.

Under traditional cost of service methodologies, the utility is responsible for raising the funds to pay for capital additions. In a subsequent revenue requirement proceeding, the utility is then authorized to recover the capital additions from customers after making a showing that the facilities placed in service are used and useful. Utilities may also begin to collect from ratepayers the cost of plant additions before they are used, if the utility can demonstrate that such additions meet the known and measurable standard. That is, the new additions "are measurable with a

6. Tr. 11/14/05 at 56(Jones).

7. Tr. 11/14/05 at 60 (Jones).

reasonable degree of accuracy and have a high probability of being in effect in the adjusted rate year." [8]

In this instance, MWC does not have easy access to additional financial resources. MWC's capital structure is highly leveraged making the prospect of raising additional equity or debt very difficult, if not impossible. Thus, the parties have sought to raise the necessary funds through an alternative mechanism, a capital surcharge. While the capital surcharge may not strictly adhere to traditional cost of service methodologies, the record evidence indicates that the capital additions are known and measurable. The Company has provided the Board with a list of the known capital improvement projects – and their estimated costs – that are currently necessary to comply with the Water Quality Division's regulations.[9] The Company will notify the Board and the Department as these projects are completed. Thus, the cost of these projects are measurable with a reasonable degree of accuracy and, because they are mandated by a State agency, are highly likely to be installed within the estimate 12 to13 month time frame. Moreover, because the funds will also be treated as contributions-in-aid of construction, the Company's rate base will not increase with the installation of the new facilities. As a result, customers will benefit in the long run by avoiding payments on the return on invested capital in a future revenue requirement proceeding, which is the case under normal cost of service methods.

Based on the record evidence, I conclude that while the proposed capital surcharge is an unconventional financial mechanism that should not be regularly considered, it is just and reasonable for the reasons mentioned above.[10] MWC has satisfied its past commitments and made a number of improvements in its operations. These past commitments prove to me that management has every intention to use the funds collected under the surcharge as intended. I

8. In Re: Green Mountain Power Corp., 162 Vt. 378, 381 (1994).

9. Exh. Joint–3.

10. Although a capital surcharge may be considered unconventional, approval of the collections of monies through rates to pay for the installation of facilities in the future is not without precedent. In Docket No. 6597, the Board approved a 39.2% rate increase for Arlington Water Company. As with MWC, the primary reason for Arlington's increase was to pay for capital improvements in the water system in order to comply with the State's water supply rules. In Arlington's case, the Board-approved rates were in effect a full year prior to the first payment on the loan Arlington used to pay for the installation of the necessary project.

also recommend that the Board require MWC to keep the funds collected under the surcharge in a separate bank account from all other operating accounts.

Rate Comparability

At the public hearing, customers expressed concerns that MWC's rates would not be comparable to the rates of other similarly-situated water companies after the proposed rate increase went into effect.

Approval of this MOU results in a 56.94% increase, and a temporary quarterly surcharge of $14.56 which will end with the March 31, 2006, bill. While the amount of the requested increase is uncommon, it is important to emphasize that MWC has not asked for an increase since 1982. To put the request into perspective, the amount of the total requested increase equals a 1.98% annual compounded rate of increase over the last 23 years. This rate of increase is roughly equal to the average rate of inflation. Had the Company sought rate relief on a more regular basis, it undoubtedly would be seeking a lower amount than it is today.

Notwithstanding the percentage increase, the proposed rates, if approved, would be fairly comparable to the rates of other water utilities of the same size.[11]

Water Company	Location	No. of Connections	Annual Metered Rate	Typical Bill assuming annual consumption of 72 K gallons
Arlington Water Co.	Arlington	458	$327.76 + 5.42/1000 Gallons over 11,000	$658
Bolton Valley Water & Sewer	Bolton	202	69.41 + $1.47 / 1000 gallons	$175
Bromley Water Inc.	Bromley	298	$177.93+$1.61/1000 gallons	$294
Burke Mountain Water Company	Burke	177	63.47+$2.76/1000 gallons	$262

11. For the purposes of this analysis, the temporary capital surcharge is omitted. Source: Vermont Department of Public Service Biennial Report: July 1, 2000 - June 30, 2004, Table 5-1, Residential Connections and Rate Information as of June 30, 2003.

Country Estates Water Company	Ascutney	188	$137.68+1.96/1000 gallons	$279
Crystals Springs Water Company	E. Montpelier	120	$375+$1.43/1000 gallons	$478
Mountain Water Company (proposed)	Warren	653	$92+$4.46/1000 gallons	$413
Smugglers Notch Water Company	Jeffersonville	343	$112 (flat)	$112

Exh. Joint - 6.

V. CONCLUSION AND RECOMMENDATION

As a result of the efforts of the Department and the Company's managers, MWC has made improvements in its financial reporting processes. These actions will help facilitate future periodic regulatory reviews and increase the transparency of inter-company transactions. The record evidence also indicates that the Company is committed to improving operations. Recent examples of their commitment have been the installation of new equipment, reducing leakage and installing meters at the Warren Fire department. These actions will enable the Company to comply with future water quality regulations at prices that are just and reasonable. All of these changes improve accountability and the economic vitality of the Company. For these reasons, I conclude that approval of the MOU is in the public good and recommend that the Board issue an order to that effect. Because the MOU results in rates that are less than those originally requested, MWC will be required to credit customers the difference between the amount of the original rate increase request of 99.71% and the 56.94% rate increase included in the MOU. I recommend that the Board direct the Company to file a proposal with the Board and the Department detailing how and when it anticipates giving the funds back to customers.

Dated at Montpelier, Vermont, this 9 day of January, 2006.

s/Thomas S. Lyle
Thomas S. Lyle
Hearing Officer

VI. ORDER

IT IS HEREBY ORDERED, ADJUDGED AND DECREED by the Public Service Board of the State of Vermont that:

1. The findings and conclusions of the Hearing Officer are adopted.

2. The Company shall file with the Board a new rate design no later than March 31, 2006.

3. The quarterly capital surcharge of $14.56, in effect from April 1, 2005, to March 31, 2006, is approved. The Company shall submit a proposal no later than February 1, 2006, detailing the amount of the customer refunds owed as a result of the MOU as well as a plan on how customers will receive the benefit of the refund.

5. The Company shall notify, in writing, the Board and the Department when capital additions are completed.

6. The Company shall maintain all funds collected under the capital additions surcharge in a separate bank account.

Dated at Montpelier, Vermont, this 20th day of January, 2006.

s/James Volz) PUBLIC SERVICE
s/David C. Coen) BOARD
s/John D. Burke) OF VERMONT

OFFICE OF THE CLERK

FILED: January 20, 2006

ATTEST: s/Susan M. Hudson
Clerk of the Board

NOTICE TO READERS: This decision is subject to revision of technical errors. Readers are requested to notify the Clerk of the Board (by e-mail, telephone, or in writing) of any apparent errors, in order that any necessary corrections may be made. (E-mail address: Clerk@psb.state.vt.us)

Appeal of this decision to the Supreme Court of Vermont must be filed with the Clerk of the Board within thirty days. Appeal will not stay the effect of this Order, absent further Order by this Board or appropriate action by the Supreme Court of Vermont. Motions for reconsideration or stay, if any, must be filed with the Clerk of the Board within ten days of the date of this decision and order.